99-619

No. _____

Supreme Court, U.S.
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In The

Supreme Court of the United States

GEORGE W. SYDNOR, JR. and THE MCGRAW GROUP, INCORPORATED,

Petitioners,

v.

N. GLENN SMITH, For himself and all Plan Participants similarly situated on behalf of the James McGraw, Inc., 401(k) Plan,

Respondent.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF IN OPPOSITION

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QUESTION PRESENTED

Whether a claim for breach of fiduciary duties by a trustee under the Employee Retirement Income Security Act of 1974 ("ERISA") requires prior exhaustion of internal plan remedies?

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STATUTORY PROVISIONS INVOLVED

The statutory provisions involved are 28 U.S.C. § 1254(1), 29 U.S.C. § 1001, 29 U.S.C. § 1104, 29 U.S.C. § 1105, 29 U.S.C. § 1106, 29 U.S.C. § 1109, 29 U.S.C. § 1132, 29 U.S.C. § 1133 and 29 C.F.R. § 2560.503-1, included in the Appendix at 24-34.

STATEMENT OF THE CASE

Plaintiff, N. Glenn Smith ("Smith") filed this action is a derivative suit filed on behalf of the James McGraw, Inc. 401(k) Plan. It asserts that George W. Sydnor, Jr. ("Sydnor") and The McGraw Group, Inc. ("McGraw") breached their fiduciary duties under 29 U.S.C. § 1104, § 1105 and § 1106.[1] This suit is brought pursuant to 29 U.S.C. § 1132 (a)(2), and seeks to hold Sydnor and McGraw[2] personally liable to the Plan under 29 U.S.C. § 1109.

On January 1, 1989, McGraw established the James McGraw, Inc. Employee Stock Ownership Plan ("ESOP"). App. 3. On December 29, 1989, McGraw adopted the Amended and Restated Articles of Incorporation (the "Articles"). App. 3. The Articles converted the stock held by the ESOP into preferred stock and provided that only preferred stock could be issued to the ESOP. App. 3. The Articles also created a significant "bundle of rights" for this preferred stock, including:

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[1] For purposes of convenience, these sections of ERISA will be referred to as § 404 - § 406.

[2] Both Sydnor and McGraw will also be referred to as the "fiduciaries."

- the right to "put" the preferred stock to the company at a price of $260.31 per share (App. 3);
- the right to receive $260.31 per share, plus unpaid dividends, if McGraw elected to redeem the stock (App. 3); and
- the right to an annual eight percent (8%) cumulative dividend for each share of preferred stock (App. 3).

On January 1, 1993, McGraw converted the ESOP into the James McGraw, Inc. 401(k) (the "Plan"). App. 3. At all relevant times, Sydnor was a trustee and fiduciary with respect to the Plan. App. 3. Sydnor was also the President and Chief Operating Officer ("COO") of McGraw. App. 2. Kenneth Fisketjon ("Fisketjon"), the Chairman and Chief Executive Officer of McGraw, served as co-trustee of the Plan until his resignation three days before the transaction in dispute. App. 3. Sydnor and Fisketjon each held fifty percent of McGraw's common stock. App. 3.

From 1990-1995, McGraw hired Willamette Management Associates ("Willamette") to conduct annual appraisals of the preferred stock. App. 4. Each year, Willamette concluded that the preferred stock had value, but the common stock "ha[d] no residual equity value." App. 4. Based on the rights granted to the preferred stock by the Articles, Willamette determined that the equity value of the company had to be allocated first to the preferred stock up to $260.31 per share. Consequently, the common stock did not have any value until the preferred stock was worth at least $260.31 per share. App. 5. Willamette concluded that the common stock was worthless each year they conducted an appraisal. App. 4.

McGraw's financial condition deteriorated during each year of Sydnor's tenure as the top executive. App. 4. Sydnor searched for investors as McGraw's financial condition worsened. App. 4. In May 1996, McGraw entered into a letter of intent with Columbia Naples Capital, L.L.C. ("CNC") in May 1996. App. 4. McGraw agreed to sell approximately forty-five percent of its common stock to CNC in exchange for a $3 million equity investment. App. 4. Like other investors, CNC was concerned with McGraw's financial obligations to the preferred stock held by the Plan. App. 4. Consequently, sometime late in the negotiations, CNC and Sydnor decided that McGraw needed to redeem the preferred stock because of the substantial liability it posed to the company. App. 4. They agreed that as part of the transaction, McGraw would redeem the preferred stock for $70.00 per share, while Sydnor, Fisketjon and McGraw would receive $66.23 per share for the common stock. App. 4-5.

Sydnor asked Willamette to issue an opinion that $70.00 per share was fair market value for the preferred stock. App. 4. Willamette refused because such an opinion would be inconsistent with its prior appraisals, which allocated all of the equity value of McGraw to the preferred stock and none to the common stock. App. 4. For example, Willamette's latest appraisal was sent to McGraw in August 1996[3] and concluded that "the fair market value as of December 31, 1995 of the [preferred stock] is $900,000 in the aggregate and $128.35 on a per share basis. Based on this value, the Class B common shares have no residual equity value." App. 4. Not surprisingly, Willamette could not agree that $70.00 per share was a fair price for the preferred stock. App. 4.

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[3] The report was dated October 15, 1996, but it was sent to McGraw sometime in August 1996. App. 4.

Undeterred by Willamette's refusal, Sydnor hired Scott & Stringfellow, Inc. to give a "fairness opinion." App. 4. Scott & Stringfellow opined that $70.00 per share was "adequate consideration" for the preferred stock. App. 4. On the same day, McGraw, CNC and Sydnor closed their deals.

As the Plan's sole trustee[4], Sydnor sold the Plan's preferred stock to McGraw for $70.00 per share. App. 4. This price was far less than the $260.31 per share provided by the Articles plus the unpaid dividends of $104.15 per share, totaling $364.46 of value per share of preferred stock. App. 5. The $70.00 per share price was also much less than the appraised value of $128.35 calculated by Willamette in its latest draft report. App. 5.

As part of the same transaction, Sydnor acting as McGraw's President and COO, McGraw sold over 36,000 shares of Class B common stock to CNC at $66.23 per share. In his personal capacity, Sydnor exchanged his shares of common stock for approximately twenty-five percent of the same stock in the recapitalized company. App. 5. His "new" shares were each valued at $66.23 per share. Sydnor also negotiated a three year employment agreement with CNC which provided an annual salary of $190,000.00; a company car guaranteed to be "no worse" than a 1996 Lexus luxury sedan; country club membership; life insurance; and the titles of President and COO. App. 5. Sydnor also received two separate incentive stock option packages and repayment of a $300,000 promissory note owed by McGraw to Sydnor by exchanging the note for shares of common stock valued at $66.23 per share. App. 5. In addition, Fisketjon sold his common stock for $584,387.02 or $66.23 per share. App. 5.

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[4] On September 27, 1996, Fisketjon resigned his position as the Plan's co-trustee -- just three (3) days before the Plan sold the preferred stock to McGraw. App. 4.

ARGUMENT

The fiduciaries – Sydnor and MGraw – profited at the Plan's expense. Smith filed this action as a derivative suit under ERISA § 502(a)(2) for relief under ERISA § 409 for disgorgement of the improper profits and restitution to the Plan.

At the district court, the Defendants argued that Smith's suit was really a disguised benefits claim and should be dismissed because Smith had not exhausted the Plan's internal procedures. Defendants, however, did not challenge Smith's argument that fiduciary duty claims were not subject to the exhaustion requirement. App. 21-22. The district court accepted Defendant's argument and dismissed the suit for failure to exhaust. The Fourth Circuit reversed. Focusing on the allegations involving the fiduciaries' self-dealing and the derivative nature of the suit, the court found that the allegations stated cogent claims for breach of fiduciary duty under ERISA § 404 - § 406. In doing so, the court also ruled that fiduciary duty claims are not subject to the ERISA's exhaustion requirement.

Defendants argue that the Fourth Circuit's decision should be reversed because (i) Smith's claim is really one for benefits under an ERISA plan which must be exhausted, and (ii) the Fourth Circuit adopted the minority position in ruling that fiduciary duty claims under ERISA are not subject to exhaustion.[5] Defendants' arguments must be discarded. The Fourth Circuit wisely rejected Defendants' argument that the instant suit was a claim for benefits simply because Smith would indirectly benefit from its successful resolution. A claim for benefits under an ERISA plan does not arise every time an

[5] Defendants argue that the Fourth Circuit should have reviewed the district court's decision for abuse of discretion. Petition for Writ of Certiorari ("Petition") at 7. Even if this was the proper standard, Defendants raise this argument for the first time in their Petition and, for this reason alone, it should be rejected.

ERISA plaintiff may "benefit" from the claim's outcome. In addition, the cases cited by Defendants as opposing the Fourth Circuits' decision do not establish that the court adopted a minority position or that there is even a split in authority regarding the exhaustion of § 404 - § 406 claims. Moreover, these decisions involve classic benefits claims and, as such, are clearly distinguishable from the case at bar. Accordingly, Defendants' Petition should be denied.

A. The Fourth Circuit's Decision Should Not Be Disturbed

The primary issue before the Fourth Circuit was whether the instant suit stated a claim for benefits or for breach of fiduciary duty. The court correctly concluded that Smith alleged a pure claim for breach of fiduciary duty that did not have to be exhausted. There is no reason to disturb this decision.

There are three types of claims under ERISA: benefit claims, fiduciary duty claims and interference claims. Benefit claims arise out of the interpretation of an ERISA benefits plan. Fiduciary duty claims arise from conduct which violates ERISA § 404, § 405 or § 406. 29 U.S.C. §§ 1104-06. Interference claims arise out of ERISA § 510, which prohibits interference with the enjoyment of benefits under an ERISA plan. 29 U.S.C. § 1140. Claims for breach of fiduciary duty and violations of § 510 involve solely the interpretation and application of ERISA's statutory provisions. As such, they are called statutory claims.

ERISA does not explicitly require exhaustion of any claims. The exhaustion requirement is rooted in ERISA § 503. This section requires every ERISA covered plan to provide an internal review procedure for participants whose claims for benefits have been denied. 29 U.S.C. § 1133. Based on this requirement, courts have inferred that Congress intended for participants to use these procedures before filing their benefit

claims in federal court. See e.g., Fallick v. Nationwide Mutual Ins. Co., 162 F.3d 410, 418 n4 (3rd Cir. 1998) (extensive list of citations).

Significantly, § 503 does not require a review mechanism for statutory claims. See Zipf v. AT&T, 799 F.2d 889, 891-92 (3rd Cir. 1986). Consequently, the public policy factors supporting exhaustion in the context of benefit claims -- namely, utilizing the administrator's expertise in reviewing and interpreting the specific plan, and giving them the opportunity to correct any errors, and build a factual record for review -- simply do not apply to statutory claims. Exhaustion of statutory claims is not necessary to permit plan administrators to use their expertise to interpret plan provisions, build a factual record for review and correct their errors because statutory claims do not involve the interpretation of a plan. See Constantino, 13 F.3d at 975. Indeed, requiring exhaustion of statutory claims would abrogate the judiciary of one of its primary functions -- the interpretation and application of laws passed by Congress -- and result in the adjudication of a splintered body of law developed by different courts and plan administrators. See Amaro v. Continental Can Co., 724 F.2d 747, 751 (9th Cir. 1984).

In addition, exhaustion of § 404 - § 406 claims serves absolutely no purpose. Most benefit plans, like McGraw's, do not provide any procedure for filing fiduciary duty claims and cannot provide any relief against fiduciaries for their misconduct. Thus, plan administrators have no authority to issue a binding judgment against a fiduciary for financial or equitable relief. Exhaustion of statutory claims is, therefore, pointless. "The law does not require parties to engage in useless acts or to needlessly squander resources as a prerequisite to commencing litigation." Fallick, 162 F.2d at 420 (quoting Corsini v. United Healthcare Corp., 965 F. Supp. 265, 269-70 (D.R.I. 1997).

Seeking to circumvent this cogent authority, Defendants argue the Smith's suit should be treated as a benefits claim because Smith would financially benefit if his derivative claim is successful. The Fourth Circuit rejected this argument. "Although the remedy will undoubtedly benefit Smith and other participants in the Plan, it does not solely benefit the individual participants .... Any recovery against Sydnor and McGraw must be paid to the Plan and not to individual participants." App. 14-15.

Relying on a portion of this holding, Defendants argue:

> The Fourth Circuit determined Smith would undoubtedly recover a benefit as a result of prevailing on his claim for an alleged breach of fiduciary duty by the plan trustees. As such, regardless of the captions applied to the claims in his pleadings, his claim is properly construed as one to recover benefits under his ERISA regulated plan.

Petition at 9. Thus, Defendants believe that this action should be treated as a benefits claim because Smith would ultimately benefit by winning his derivative claim. This is the main premise in Defendants' Petition. It is also its fatal flaw.

A claim for benefits under an ERISA plan is not the same as receiving a "benefit" as used in the general sense. The distinction between benefit claims and the instant case illustrates this point. Benefit claims are filed by individuals to challenge an administrator's interpretation or implementation of a particular plan. However, Smith concedes that his retirement benefits were calculated and distributed correctly under the terms of the Plan. Smith instead challenges the fiduciaries' handling of the Plan's assets (i.e., the preferred stock). Smith filed this action as a derivative claim asserting that the fiduciaries undersold the Plan's preferred stock to reap

personal profits at the Plan's expense. Thus, even if he is successful, Smith cannot recover individually; all recovery must go directly to the Plan. See Massachusetts Mut. Life Ins. v. Russell, 473 U.S. 134, 146-47 (1985). To receive any "benefit," Smith must apply for supplemental retirement benefits after the award is placed in the Plan. Even though Smith may ultimately receive these "benefits," this by itself does mean that Smith's derivative claim should be treated, even partially, as a claim for benefits.

Defendants further ague that the instant claim is really one for benefits because " . . . Smith seeks to recover money damages on behalf of himself and other members of the putative class of plan participants." Petition at 7 n8. This is only partially correct. Smith actually filed this action " . . . for himself and all Plan participants similarly situated on behalf of the James McGraw Inc. 401(k) Plan." App. 1. (emphasis added). Thus, Smith is not seeking any individual benefit from the instant claim. He is solely exercising his right to sue on behalf of the Plan for the relief provided in § 409 of ERISA.

Accordingly, the Court must reject Defendants' attempts to transform the instant suit into a benefits claim. The Fourth Circuit properly rejected this position, decided that Smith's allegations stated a pure claim for breach of fiduciary duty and refused to apply the exhaustion requirement to Smith's claim. Defendants have failed to assert any cogent reason to disturb this result.

B. Defendant's Proposed "Majority" Rule Does Not Exist.

Defendants contend the First, Second, Fifth, Sixth, Seventh and Eleventh Circuits have adopted the so-called majority rule requiring exhaustion of ERISA statutory claims. Petition at 3. Defendants further contend the Fourth Circuit deviated from this majority by determining fiduciary duty claims are not subject to exhaustion. However, the cases

adopting the "majority" rule involved primarily the exhaustion of benefit claims. Consequently, Defendants' "majority" position does not exist.[6]

In Drinkwater v. Metro Life Ins. Co., 846 F.2d 821 (1st Cir. 1988), cert. denied, 488 U.S. 909 (1988), the First Circuit ordered exhaustion where a plan participant filed suit challenging the calculation of his disability benefits. The court wisely rejected the plaintiff's argument that any improper denial of benefits also constitutes a breach of fiduciary duty.

In Alfarone v. Bernie Wolff Constr. Corp., 788 F.2d 76 (2nd Cir. 1986), the Second Circuit applied exhaustion to a claim filed by union trustees to recover delinquent contributions to a union pension fund. The trustees had to proceed initially through arbitration because that process was provided for under the applicable collective bargaining agreement and plan documents.

In Simmons v. Wilcox, 911 F.2d 1077 (5th Cir. 1990), the Fifth Circuit ordered exhaustion where the employee claimed she was denied benefits under a health plan and that the fiduciaries wrongly withheld information regarding the status of her benefits. Id. at 1081. The Fifth Circuit found no merit to her claims for denial of information and dismissed the remaining claims because they were benefit claims which had not been exhausted.

The Sixth Circuit decision cited by the Defendants -- Constantino v. TRW, Inc., 13 F.3d 969 (6th Cir. 1994)-- involved a class action filed by retirees challenging the calculation of their early retirement benefits. Exhaustion did not apply because the plaintiffs challenged the legality of the particular plan amendment and not the administrator's interpretation of the plan.

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[6] Before the district court, Defendants did not challenge Smith's contention that the exhaustion requirement did not apply to fiduciary duty claims. App. 22.

In Lindemann v. Mobil Oil Corp., 79 F.3d 647 (7th Cir. 1996), the Seventh Circuit applied exhaustion to § 510 claim where the plaintiff claimed her termination was designed to interfere with her right to take sick days.

In Mason v. Continental Group, Inc., 763 F.2d 1219 (11th Cir. 1985), cert. denied, 474 U.S. 1087 (1986), the Eleventh Circuit to another § 510 claim where employees filed a class action alleging that their employer closed its plant and terminated plaintiffs' employment because it wanted to prevent the plaintiffs from attaining rights and benefits under a comprehensive benefit plan administered by the employer.[7]

As these decisions illustrate, Defendants' asserted majority position does not exist. The decisions from the First, Second, Fifth and Sixth Circuits clearly do not apply to the instant claim. They each involve classic benefit claims where a plan participant is challenging the calculation or denial of their benefits under an ERISA plan. None of these cases involve the allegations in the instant claim where a participant filed a derivative claim to challenge the treatment of the plan by the fiduciaries. Moreover, these decisions adhere to the approach adopted by the Fourth Circuit where benefit claims must be exhausted but fiduciary duty claims do not. Compare Makar v. Health-Care Corp., 872 F.2d 80, 82 (4th Cir. 1989) (participant challenging denial of benefits must exhaust internal plan remedies) with Smith v. Sydnor, 184 F.3d 356 (4th Cir. 1999) (claims for violations of § 404 - § 406 do not have to be exhausted). Accordingly, Defendants' reliance on these cases to form a "majority" position must be rejected.

Defendants' reliance on the Fifth and Sixth Circuit decisions -- Simmons and Constantino -- is further suspect because both these circuits decided in other cases not to apply exhaustion to statutory claims. See Chailland v. Brown &

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[7] In Mason, the employee asserted his § 404 and § 406 claims for the first time on appeal. 763 F.2d at 1225.

Root, Inc., 45 F.3d 947, 950-51 (5th Cir. 1995) (no exhaustion for § 510 claim because plan is incapable of providing a remedy); Richards v. General Motors Corp., 991 F.2d 1227, 1235 (6th Cir. 1993) (exhaustion not required for § 510 claims).

Defendants' "majority" position, therefore, amounts to the decisions in Lindemann and Mason. While both these decisions upheld the dismissal of § 510 claims for failure to exhaust internal plan remedies, they did not directly involve the exhaustion of § 404 - § 406 claims. Thus, even if this Court acknowledged the Fourth Circuit's decision is at odds with Lindemann and Mason, this Petition should still be denied because the instant claim is not the proper case to address this issue. To the extent any split exists on the exhaustion issue, it is between benefit claims and § 510 claims. Thus, a § 404 - § 406 claim, like the instant claim, is not the proper context in which to resolve this split. Accordingly, Defendants' Petition should be denied.

CONCLUSION

The Fourth Circuit's decision should not be disturbed. The court correctly determined that the instant suit was not a claim for benefits and that fiduciary duty claims under ERISA do not have to be exhausted. To overcome this decision, Defendants urge this Court to adopt a new rule requiring exhaustion of any ERISA claim which may ultimately benefit the claimant. Such a rule would turn every fiduciary duty claim into one for benefits and, as such, it must be rejected. Moreover, Defendants' attempt to create a "majority" rule requiring exhaustion of the instant claim must be rejected because this "majority" position simply does not exist.

Accordingly, Defendants' Petition should be denied.

Dated: December 10, 1999

Respectfully submitted,

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